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USA
Airlines

Airline Mergers: Potential Benefits and Risks

- Ray Neidl presented today on M&A activity in the airline sector to the House Committee on Transportation and Infrastructure Subcommittee.
- Reasons for mergers: the industry remains too fragmented in an era of historically high fuel prices, which is threatening the industry because it lacks ticket price discipline.
- Certain mergers make sense and do not significantly reduce competition if they are end-on-end such as the proposed Delta-Northwest merger.
- The benefits of a merger would include the opportunity to reduce costs, increase the scope of the airlines route system to better serve customers, and enhance revenue through a larger system.
- The main risk is the complications of trying to merge two large and diverse systems, especially in the labor, fleet and computer components. If the two carriers are already in the same alliance, such as Delta-Northwest, this task would be simpler.

There will be industry consolidation one way or another, in our opinion. Either the carriers will be allowed to merge in a logical manner to make the industry less fragmented or eventually certain airlines will fail and possibly liquidate disrupting the careers of employees, disrupting service, and destroying investment capital in the process. Any liquidation of a major carrier would create the same efficiencies as created by a merger, in that surplus seats will be taken off of the market, but it would be in a more disruptive manner.

Airlines would expect to benefit in three main ways through mergers including cost savings through the elimination of duplicate operations, revenue enhancement through synergies from a larger system and stronger pricing power, and increased scope and the ability to attract additional passengers through a broader product line offering (more destinations). The question is how achievable these goals are and in what timeframe could they be achieved.

We do not believe that a merger can be justified only on potential additional revenue synergy of the combined carriers since a large part of any advantage gained would be short-term and neutralized as other carriers merged and evened the playing field. Unit revenue would have to be increased as a result of any merger through tighter yield management and/or price increases resulting from a more stringent control of seat inventory in the industry. Both can be done, we believe, and should strengthen the revenue side of the ledger in the long run.

Main benefits of Airline Mergers

Cost Reductions

- To justify the expense and risk of a merger, cost cuts would be needed. Merging two carriers with route overlap would contribute towards this but would have greater difficulty passing regulatory scrutiny.

- A merger with little route overlap would not produce the major cost savings that investors would be looking for immediately, since the merged systems have to be evaluated as to where costs can be saved and guarantees made at the time of the merger would have to honored for a reasonable period of time.

- Costs may actually be higher in the first year as the two systems are integrated and costs resulting from possible service disruptions during the integration period could add to this.

- A major risk is that in order to get labor support for any combination, wages and benefits might have to be increased, raising overall unit costs and putting a greater cost burden on any merged carrier.

- Ultimately, facilities would have to be consolidated including under-performing or duplicate hubs in order to achieve major cost savings. For political and business reasons this would take time, probably years to accomplish.

Increased Scope of Service

- A single carrier cannot serve all areas of the world on its own and, as a result, a system of worldwide partnerships has evolved to meet customers' needs.

- Network airline carriers have been able to serve their customers worldwide through joining one of the three worldwide partnerships, OneWorld, SkyTeam or the Star Alliance. However, it does not offer the complete service as flying on the same carrier does, and the host carrier loses control of the passenger, plus some of the revenue generated by the ticket sale, as it is shared with the partner.

- Being able to keep your passengers on your own product under one name gives the customers a feeling of continuity and would be beneficial in guaranteeing the same level of service and keeping all of the revenue generated by the ticket.

Revenue

- In the short-term, the merged carrier would have the ability to enhance revenue through a broader product offering.

- The initial revenue spurt may be short-lived, however, and could eventually be neutralized if other carriers merged and then were able to offer as broad a product line. This conclusion is not totally definitive since all combinations are not equal and a weaker rival merger might not produce as strong as a competitive system.

- The carriers' main benefit from mergers regarding revenue generation in our opinion is that they would, as an industry, have greater pricing power, since a less fragmented industry would have greater control of the seats being offered.

- Long-term, even the advantage of having greater marketing power could be eroded as low-cost carriers move in to fill any voids left by consolidating carriers pulling out of marginal markets or hubs.

- However, strong worldwide airlines with large strategic hubs would be able to service a broad sector of the traveling public through these strengths. Worldwide partnerships, even if they had anti-trust exemption, cannot offer as broad a product line as a single carrier can. By being able to serve the customer in a more cost effective manner, investors would benefit.

Main Risks of Airline Mergers

In the past, most airline mergers resulted in a deterioration of service during the initial stages of integration

Airline mergers tend to be time consuming and expensive. If not properly planned and executed, it can turn into a nightmare of logistics as employee groups, fleets, computer systems, and cultures are merged. In the past, most airline mergers resulted in a deterioration of service during the initial stages of integration, drawing the wrath of the travelling public and ultimately attracting the attention of the politicians.

A major risk would be to have multiple airline mergers trying to be implemented at the same time whereby a large part, if not a majority, of the domestic system is negatively affected as integration takes place.

This is a service industry and employee cooperation is needed to make a merger work. Management may be tempted to buy off labor for their support but in the process raise their costs, which could entirely negate the benefits of any merger. This has to be avoided.

We believe some merger-related problems can be reduced if the two airlines have worked in a partnership before the attempted merger, such as we have in the case of Delta and Northwest. Further, in the case of Delta and Northwest, if they can get a pilot agreement pre-merger, it should make the integration easier but this, as in any merger, still poses some risk.

One of the main problems in trying to integrate two airlines is meshing the work forces

One of the main problems in trying to integrate two airlines is meshing the work forces. Ironically, the only U.S. airline merger post-deregulation in 1978 that went fairly smoothly from the beginning was the Delta acquisition of Western Airlines. Good planning and execution were a key part but we believe that fact that Delta was largely non-union made the integration much simpler.

Is Re-regulation or Nationalization of the Industry the Answer?

Some suggest that the industry should be nationalized or run like a public utility. Our prediction is that we will not have a nationalized airline industry under any circumstances. There will be an airline industry but it will be private and restructured through merger and/or bankruptcy actions. We envision possibly a more 'virtual" structure eventually evolving in which airlines provide the basic service and other functions go to specialized companies such as aircraft leasing, maintenance, possibly marketing and other functions that the airlines currently do themselves.

What we need is a more rational structure of the industry, keeping it competitive but not fragmented

Politicians of all stripes do not want to get the government involved in this industry since they realize that ticket prices would rise substantially on fewer services and that even taxpayer money may have to be involved. Foreign countries would condemn such a move since they have been going the other way in privatizing their carriers. They are basically tired of having their taxpayers subsidize airline service, and correctly so. A nationalized industry would be a tremendous burden on the taxpayer, non-responsive to consumer needs, inflexible in adjusting to market changes, and become a service for only the wealthy, something that is totally unacceptable in today's political environment. What we need is a more rational structure of the industry, keeping it competitive but not fragmented. Also remember, barrier entries are relatively easy and when the smoke clears we will have a new stream of start-up airlines with their own new unique model, such as Virgin America. Private start-up capital always seems to be available without any government involvement.

Everyone is in the same boat and they must help the airline by paddling in the same direction as everyone else

The airlines are not the only ones who will have to learn to adapt. The powerful labor unions, particularly the pilots, will have to realize that cooperation and not confrontation is in their best interests. Everyone is in the same boat and they must help the airline by paddling in the same direction as everyone else instead of trying to poke holes in the boat to sink it. They would drown just as quickly as everyone else. On the other hand, the workers have to confidence that management is working in their best interests and looking out for them as much as they are looking out for themselves. All parties have to be rowing in the same direction for the mutual benefit of the workers, the company, consumers and the investor.

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